CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 180

March 2, 1956

LOSS DEDUCTION: EMBEZZLEMENT LOSS VS. BAD DEBT: PROPER YEAR

Syllabus:

Where an embezzler expressly promises to repay embezzled sums, the loss is compensated for by the debt thereby created and if the promise later proves worthless only a bad debt deduction is allowable and it must be taken in the year the debt proves worthless.

X, president of Y Corporation, made unauthorized withdrawals of $750,000 from the corporation during 1952 and 1953 which were recorded on the corporation's books as additions to accounts receivable from X. In October of 1953 he promised to repay the amounts taken. In February, 1954, he transferred his assets to the corporation to repay the amounts taken and was given a release from further liability. It was discovered later in 1954 that the assets transferred were insufficient to meet the claims against X.

Advice is requested as to whether Y Corporation is entitled to a total embezzlement loss in 1953 or only to a net embezzlement loss or bad debt deduction in 1954. Held: Y Corporation is only entitled to a bad debt deduction in 1954 for the difference between the amounts taken and the amounts realized on the assets transferred by X.

The fact that X made no attempt to conceal his withdrawals of corporate funds does not prevent his unauthorized acts from constituting the crime of embezzlement. (People v Talbott, 220 Cal. 3; People v Colton, 92 Cal. App. 2d 704 at 710). The general rule which provides that embezzlement losses are deductible in the year of the theft or, in some cases, when the theft is discovered, is not applicable however when the embezzler makes an express promise, as distinguished from an implied-in-law promise, to repay. Still v Comm., 19 TC 1072, aff'd 218 F2d 639; Appeal of First National Bank of Glendale, State Board of Equalization, June 3, 1933; Appeal of Odd Fellows Temple Association of Pasadena, State Board of Equalization, October 25, 1935.

A loss is not deductible to the extent that the taxpayer has received compensation therefore (Regulation 24121d(1)) and the theory of the above decisions is that an express promise to repay the embezzled sums creates a debt which compensates for the loss. If the debt subsequently proves to be worthless, or partially worthless, as in this case, the taxpayer is entitled to a bad debt deduction in the year it became worthless (1954 in the instant case) under Section 24348 of the 1955 Personal Income Tax Law.